

Public Utility Commission of Texas

Memorandum

TO: Chairman Donna L. Nelson
Commissioner Rolando Pablos

FROM: Commissioner Kenneth W. Anderson, Jr.

DATE: March 21, 2012

SUBJECT: Open Meeting of **March 22, 2012, Agenda Item No. 13, Docket No. 37897:**
P.U.C. Proceeding Relating to Resource and Reserve Adequacy and Shortage Pricing.

Resource adequacy within ERCOT is currently this Commission's top priority. During the March 7, 2012 open meeting, we discussed Chairman Nelson's resource adequacy proposals as set out in her March 6, 2012 memorandum in this project. There was much in the memorandum with which I agreed, including that: (1) the system-wide offer cap (SWOC) must be raised and that the cap on the Power Balance Penalty Curve (PBPC) should ride up with that increase, unless we decide to direct ERCOT to raise the cap on the PBPC before we raise the SWOC, (2) the triggering mechanism for the Peaker Net Margin (PNM) needs to be changed, (3) we want to implement voluntary mitigation plans in lieu of re-writing the Commission rules on market power abuse,¹ and (4) we want to work with the Brattle Group as part of a comprehensive look at the resource adequacy issue so that we consider all of the possible alternatives that may be necessary to ensure that we are doing what is necessary to encourage generation investment in Texas. We also agreed to continue discussing these issues at the March 22, 2012 open meeting.

Raising the SWOC this Summer

I share the Chairman's concerns about resource adequacy in general and her specific short-term desire to incent mothballed units to come back online for the summer of 2012. But we have already completed, or will soon complete, a number of market initiatives that should be sufficient to incent those units to come back online this summer, most significantly (1) moving 500MW from non-spinning reserve service to responsive reserves and (2) pricing energy from (i) responsive reserves, (ii) regulation-up service, and (iii) units acquired by ERCOT for system capacity through the reliability unit commitment process (RUC) at the SWOC. These changes should increase the frequency and duration of higher wholesale energy prices when system scarcity conditions occur in the wholesale market. I don't think we will know the full impact of the changes we have already made until those changes have been in effect for all or most of a summer season. Therefore, at this time, I believe we should let the market work and, instead focus upon the longer-term issues of (1) the structure and amount of the PNM mechanism (and the low system wide offer cap (LCAP)) and (2) the magnitude and timing of increases to the SWOC. I remain firmly convinced that these permanent changes, particularly an increase in the SWOC, will do more to influence the forward power markets than an action that delays giving

¹ P.U.C. SUBST. R. 25.504(e).

the market the critical information that market participants need to plan, finance and build new generation.

While I agree in concept with much of Chairman Nelson's approach, for a number of reasons I remain concerned with raising the SWOC this summer. First, for reasons also discussed in more detail below, I believe Staff resources used in the rulemaking are better utilized in the "permanent rule changes". In order to implement a rule to raise the SWOC before July 1, 2012, Staff would have to shorten significantly the comment and reply comment deadlines. Shortened deadlines could result in rushed and inferior input from market participants and might deter some market participants from filing comments at all, thereby increasing the risk of resulting unintended consequences.

Second, and more importantly, publishing the rule to raise the SWOC for this summer means that the Commission can not address the far more important permanent rule changes that are necessary to provide long-term price signals. Staff would be unable to publish the rule for permanent changes until after the interim rule is final, thereby delaying the process for months.² Rather than having the permanent rule in place in the late summer, it would be the end of the year or later before the new rule would be in place. Not having the permanent changes to the SWOC for 2013, 2014 and 2015 will suppress forward prices, which is exactly the wrong signal to send. Instead, this temporary increase will produce additional long-term uncertainty. For these reasons, I do not support rushing through an expedited rulemaking proceeding in order to raise the SWOC by July 1, 2012. I believe the permanent changes to the SWOC are much more important to resource adequacy than racing to increase the SWOC for this summer.

Third, market participants may, I fear, have insufficient time to re-adjust their risk strategies, including planning for any increase in ERCOT collateral that may be required. Will there be sufficient time for all of the parties to adjust their financial exposure? How will such a sudden change affect liquidity in the ERCOT market? Will financial counterparties in hedging arrangements continue to be willing to participate, and if so, at what cost, if the SWOC is increased significantly on such short notice.

Finally, I am concerned about the effect on bilateral contracts from an increase in the SWOC. It is widely believed that more than 90% of the power in ERCOT is sold pursuant to bilateral agreements, which permit load serving entities to offer, stable fixed-rate products to residential customers. For residential customers in competitive areas who are on fixed rate contracts, P.U.C. SUBST. R. 25.475, limits the ability of Retail Electric Providers (REPs) to increase charges during the term of the agreement. One exception to that restriction is for "changes resulting from...state...laws that impose new or modified...costs on a REP that are beyond the REP's control".³ This provision would arguably enable REPS that offer fixed-rate products to raise their retail prices to cover the costs associated with the difference between the current SWOC and any change approved by the Commission. A mid-term contract increase would be very, very disruptive to the retail competitive market and should be avoided unless absolutely necessary. This is an issue that we must take very seriously and consider carefully.

² 1 TEX. ADMIN. CODE § 91.35(k) (2003) (Tex. Secretary of State, How to File Proposed Rules).

³ P.U.C. SUBST. R. 25.475(b)(5).

If, however, a majority of my colleagues decide that an increase in the SWOC for this summer is warranted, I strongly urge that it be done by raising the cap on the PBPC. This approach is vastly preferable because it (1) can be done administratively, and thus more quickly, at ERCOT without major system changes, (2) would avoid delaying the permanent rule project described below that I believe is critically necessary, and (3) may significantly reduce the likelihood that Substantive Rule Section 25.475(b)(5) can be invoked by REPs to pass through unforeseen costs to their residential customers. I believe that raising the cap on the PBPC is likely to have the same price impact on the wholesale market because very few, if any, resources are likely to bid at the SWOC. I would note, however, that if this approach is taken, it will be necessary for ERCOT to revisit most of its recent changes to its protocols so that energy from responsive reserves, regulation-up service and units acquired for capacity through RUC are priced at the new temporary PBPC price cap, rather than the SWOC, in order to avoid price reversals. Furthermore, the Commission will have to direct ERCOT to file for a good cause exception from the Commission's rule of not submitting bids in excess of the SWOC⁴ so that owners of generation submitting energy bids for responsive reserves can do so at the temporary cap on the PBPC.

Permanent Rule

For all the reasons that I have previously summarized, I remain firmly convinced that permanent and long-term changes, particularly the increase in the SWOC, will do more to influence the forward power markets and provide the market with the most critical information needed to plan, finance and build new generation, I would direct Staff to move forward with a rule-making project to raise the SWOC and explore the PNM mechanism. Furthermore, I would like to see the rule published for comment before the end of May and adopted by the Commission before the end of this summer, certainly no later than the end of September.

It is my opinion that adopting a final rule late this summer based on a fully developed and considered record that includes the recommendations of the Brattle Group study and one of the three cases I have proposed would send a stronger signal to the market than rushing through an expedited rulemaking so that we can raise the SWOC to \$4,500 on July 1, 2012 with some future, but unclear, indication that we might go higher. We need to give market participants the certainty of a clear and long-term market design so that they can consider, understand and plan accordingly.

Comment deadlines should allow sufficient time for parties to consider and comment on the results of the Brattle Group study. In addition, I believe that the proposed rule should include and seek comment on the following three alternatives for raising the SWOC. I would also ask that the Brattle Group be ask to evaluate the three alternatives. Any of the three cases I propose should provide owners of generation with a materially increased opportunity to earn a sufficient return on the investment, if they place new generation in service over the next 18-months to four years.⁵

⁴ P.U.C. SUBST. R. 25.505(g)(6)(D).

⁵ Currently, I am personally inclined to agree with Chairman Nelson that the SWOC ultimately should rise to at least \$7,500, but would like to review and consider input from both the comments and the Brattle Group before making a final decision.

	Raise the SWOC to:	Effective before the summer of:
Case 1	\$4,000	2013
	\$5,000	2014
	\$6,000	2015
Case 2	\$4,500	2013
	\$6,000	2014
	\$7,500	2015
Case 3	\$5,000	2013
	\$7,000	2014 or 2015
	\$9,000	2015, 2016 or 2017 ⁶

During the comment period, I hope and strongly encourage that all of the participants in the ERCOT market, load-serving entities, resource owners and financial participants, will encourage their respective counterparties (financial or otherwise) to participate in our rulemaking and comment on the three options to raise the SWOC. I believe we truly need input from all of the entities that participate in ERCOT's market and the ERCOT shadow markets.

With respect to all of the issues related to PNM, I am fine with asking the Brattle Group to consider whether the PNM construct in Commission substantive rules is the appropriate mechanism to measure resource adequacy in an energy-only market, and if not, what should replace it. If they believe it continues to have merit, I welcome their input as to how to improve the mechanism. For purposes of the proposed rule, I am fine with the Chairman's proposal to raise the PNM threshold to \$262,500 and the LCAP to \$2,000. I would direct Staff to ask stakeholders for comment as to whether the mechanism should be further modified, and if so, how it should be modified. Personally, if the PNM is retained I am inclined to prefer setting the PNM amount periodically based on some multiple of the cost of new entry as calculated by ERCOT and that the LCAP trigger is pulled only if it is exceeded over some consecutive time period.

Other Issues

PBPC. I am fine with the slope of the PBPC, but will remain open to its refinement in the ERCOT stakeholder process if that is the preference of the ERCOT market participants. However, I believe that once the PBPC is triggered, price reversal should not occur. Generally, it should not, unless the SWOC is below the cap on the PBPC. However, because of some of the other changes that have been made to the market, I do believe that the starting "bid" should be increased from its current level of \$200 to at least \$500.

⁶ With the "High Case", these dates are somewhat illustrative, because with this alternative, the increases could be phased in over a slightly longer period of years in order to give market participants more time to adjust to the magnitude of the risk. However, this time-period probably should not exceed five years from the end of 2012.

Market Abuse Issues. I have struggled with whether we should clarify what is “substantially above marginal cost” for purposes of SUBST. R. 25.504 and 25.505, but I would **not ask** Brattle to consider whether our bidding rules should be amended to allow for full-cost bidding rather than marginal-cost bidding (emphasis added). To be clear, currently our rules do not limit bids to marginal cost.⁷ Furthermore, I don’t believe we could amend the rule to provide the confidence that the owners of generation seek without explicitly or implicitly setting a specific dollar amount. Such a solution would ignore the different economic conditions and circumstances of each owner in ERCOT. Taking that action would in effect create a price floor (or ceiling depending upon how it was done), thereby distorting the market.

Additionally, I am neither for nor against raising the small fish exemption.⁸ But, no matter what we do, there will always be a resource owner that is just under or over the safe harbor threshold and who will complain about uncertainty. As I have said several times, I believe that bidding issues are better worked out on a case-by-case basis through the use of voluntary mitigation plans (VMP) under the Commission’s expanded authority.⁹ At least for now, I believe that VMPs are the proper way to approach issues relating to generation bidding strategies. Consequently, I would not open SUBST. R. 25.504 or 25.505 at this time.

I look forward to discussing these issues with you during the open meeting.

⁷ P.U.C. SUBST. R. 25.504(d) (stating that a generation entity with market power that prices its services substantially above its marginal cost may be found to be withholding production; offering prices that are not substantially above marginal cost does not constitute withholding of production); *see e.g. TXU Generation Co., L.P. v. Pub. Util. Com’n of Tex.*, 165 S.W.3d 821, 836-7 (Tex. App.—Austin 2005, pet. denied) (stating that the Court did not read statements in the preamble to the rule as setting the price of power at “marginal cost” and further stating that in light of the administrative record and the explicit statements by the Commission that its wholesale market oversight rule does not require marginal-cost pricing, the Court found no merit in the theory that a market participant will be coerced into setting prices at an unprofitable rate out of an unsubstantiated fear that the Commission will initiate an investigation).

⁸ P.U.C. SUBST. R. 25.504(c).

⁹ Public Utility Regulatory Act, TEX. UTIL. CODE ANN. § 15.023(f) (Vernon 1998 & Supp. 2010-11) (PURA).

